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CONGRESSIONAL TESTIMONY

The Making Home Affordable Program

**Testimony before
Subcommittee on
Housing and Community Opportunity
Committee on Financial Services
United States House of Representatives**

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My name is David John. I am Senior Research Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

On February 21, 2009, President Obama released his Homeowner Affordability and Stability Plan, now known as Making Home Affordable, to help stabilize the deeply troubled housing finance market by providing several forms of assistance to as many as 7-9 million borrowers who may be at risk of defaulting on their mortgages. The broad outlines of February were filled in by detailed guidelines for the implementation of the program that were issued by the Treasury Department in early March.

Two of the initiative's three key components are designed to provide subsidies and benefits primarily to homeowners who are still current in their payments. The first The Home Affordable Refinance program will assist those who may not be able to take advantage of attractive refinancing opportunities at lower interest rates because the value of their home has declined beyond the loan-to-value ratio permitted by rules governing mortgage investments made by Fannie Mae and Freddie Mac. The second, The Home Affordable Modification program would provide taxpayer and investor subsidies to mortgage borrowers who have taken on more debt than they could safely manage including, in some cases, credit card and automobile debt. An extremely dangerous third component of the plan, which is beyond the scope of this hearing, encouraged the enactment of legislation allowing bankruptcy judges to alter the terms of certain mortgage loans, a practice that to date has been prohibited by federal law.

The Obama plan suffers from 12 specific weaknesses and risks:

1. The plan's Home Affordable Modification program bestows new and costly benefits on those who took on more debt than they could handle, including credit cards, automobile loans, and mortgages (including refinancings and seconds). Worse, the value of the benefits will vary in direct proportion to the degree of borrower financial irresponsibility, and the intensity of community land regulations. Homeowners with a first mortgage as large as $729,750 are eligible for the initiative, meaning that the well-to-do will receive more financial benefits than those of modest means. And as analysts at one nationwide financial firm noted: "The modifications would go disproportionately to borrowers who overstretched and who lied about their income." This moral hazard sends a clear message to the American people: The worse the behavior the greater the reward.

2. Under this program borrowers with a ratio of mortgage debt service to income greater than 31 percent can have their mortgage interest rate reduced to as little as 2 percent if that is what it takes to achieve the 31 percent ratio—with government paying half the subsidy and the investor/lender surrendering the other half. If this concession is insufficient to reach 31 percent, then the servicer (as opposed to the lender/investor holding the mortgage) can lengthen the term of the loan and/or reduce the principal amount owed to achieve the 31 percent. Eligibility appears to be based solely on the debt-to-income ratio with no apparent minimum or maximum loan-to-value ratio.

3. Borrowers under the modification program with a ratio of debt service payment to income as high as 55 percent—because of combined mortgage, credit card, and automobile debt—will be eligible to receive temporary payment reductions if they merely agree to HUD-approved counseling. Such borrowers may then be eligible for permanent payment reductions.

4. One of the most absurd provisions of the initiative is why consumers who have their loan modified, and thus save thousands of dollars a year in reduced payments, should also receive an additional $1,000 a year in principal reduction for the first five years of the program in return for keeping their payments current. The amount is too low to be much of an incentive since in most cases it would be less than one month's mortgage payment, and in any case only goes to reduce the principal. Why homeowners who have received so much with taxpayer assistance should be eligible for yet more assistance is a mystery.

5. Because the investor/lenders will be responsible for a portion of the mortgage rate reduction, this program will deter private sector investment in all but the best mortgages. Combined with the proposed "cram down" bankruptcy proposals, the net effect will be to require a substantial and permanent federal presence in the housing finance market to accommodate those many potential borrowers who are not highly qualified.

6. The plan also includes a formal endorsement by the President of a bankruptcy provision that allows judges to alter the terms of certain mortgages. While as noted, this legislation is beyond the scope of this hearing, its passage would make it even harder for the rest of the initiative to succeed. This provision will increase the risk to lenders of all mortgages. The industry is already treating this as a permanent measure. Increased risk requires higher costs to compensate lenders, and either down payments or interest rates would have to rise, while potential borrowers with checkered credit histories would be denied access to credit. However, these costs would not rise evenly for all borrowers: Higher risk borrowers (first-time buyers and moderate-income workers) would see costs increase more and have fewer opportunities to buy a house.

7. The Home Affordable Refinance program creates a new right for American borrowers now current in their mortgage payments: the right to refinance their home at a lower interest rate even if the quality of the loan—as measured by the

loan-to-value ratio—would otherwise pose a risk to the lender. As such this proposal establishes the act of being highly leveraged or slightly "underwater" (the amount that a borrower owes on his or her mortgage is more than the value of the house) as a legitimate reason to default, and as a policy problem worthy of taxpayer support and federal intervention. The creators of this new right fail to recognize that many other consumer credit markets operate comfortably, successfully, and safely despite the fact that many borrowers are underwater the minute they sign the contract, notably home improvements, mobile homes, automobiles, RVs and HDTVs. Though those borrowers do expect to be "underwater" for these kinds of purchases, it raises the question of whether future legislation will extend this concession to car loans and credit card debt, which are also experiencing significant levels of default?

8. Only borrowers with loans held or repackaged by the federally-controlled and subsidized Fannie Mae and Freddie Mac will be eligible to exercise this new right to refinance. Borrowers whose loans are held by private investors are denied this right, further distorting the housing markets with government-selected winners and losers.

9. To date, the several, federal loan modification programs that have been put in place have had very limited success, and the rate of failures exceeds that of successes, especially for loans where one or more payments have been missed. For loans that were four months past due at time of modification the recidivism rate is 80 percent after 12 months. For loans one month past due, the recidivism rate after 12 months is 60 percent. With the nationwide decline in house prices accelerating in recent months, the risk of recidivism under the new program could remain at high levels.

10. The overall initiative will cost $275 billion ($75 billion for problem mortgages and $200 billion for Fannie Mae and Freddie Mac).

11. The initiative will take a great deal of time to implement. A recent MarketWatch.com article notes that loan refinancing applications are up 47 percent at a time when a substantial portion of the loan originating infrastructure has disappeared due to bankruptcy and bank consolidation. The prospect that a shrunken mortgage lending system could expeditiously accommodate the 7-9 million borrowers expected by the Obama plan is wishful thinking. The result will be long waits for refinancing that will come too late for some borrowers, and may also crowd out efforts by unsubsidized borrowers to refinance due to the generous financial incentives offered to servicers participating in the new federal program.

12. Perhaps the most troubling part of the plan is the increased reliance being placed on the now federally-controlled Fannie Mae and Freddie Mac, whose lax and corrupt behavior over the past decade was an important contributing factor to the present economic crisis. Although nominally privately-owned, both are now run by the U.S. Treasury, whose massive holdings of preferred shares in both give it a huge implicit ownership stake. As is clear from the refinancing plan—which will

> reduce Fannie and Freddie's earnings and thus weaken them further—the two GSEs have become little more than the federal government's captive mortgage financing banks to be used at will for any housing policy initiatives that the President and/or Congress wish to pursue. And with the plan's many provisions discouraging the private sector from getting involved in mortgage finance, this plan substantially advances the de facto nationalization of America's housing finance system for all but the "jumbo" mortgages that exceed conforming limits.

While I am critical of the President's initiative, I am very aware of the pain and disruption that losing a home causes a family. Several of my neighbors in my West Virginia neighborhood have lost their homes to either foreclosure or the scavengers who offer to help homeowners in trouble and end up with their houses. However, I can find little justification for extending assistance to people who bought a home that was well beyond their ability to afford, refinanced homes in order to draw down equity to finance an extravagant lifestyle, or abused the system by lying. Despite the best of intentions, congressional efforts to deal with foreclosures have had moral hazard problems, have greatly failed to reach the number of people intended, or both.

While the guidelines for the overall initiative will weed out certain of these people from benefiting from the Making Home Affordable initiative, there will still be many instances where homeowners who have sacrificed in order to keep their mortgages current will see their neighbors who have acted irresponsibly treated the same way that they are. The moral hazard created by this situation is equally unfair to those who have paid off their mortgages and to those who rent. The message that is sent to homeowners, and especially our children and grandchildren – that they will not have to face the consequences of their decisions – will result in lasting damage and almost certainly calls for yet more bailouts the next time the economy turns sour.

A Proposal for the Future

However, let me take this opportunity (since I rarely appear before this subcommittee) to suggest a way to make it simpler for future generations to build savings for items such as down payments on housing. It is clear that foreclosures and defaults rise when a homeowner has not made any sort of major down payment. On the other hand, many assets initiatives such as Individual Development Accounts show that workers at all income levels are interested and willing to save. These efforts are even more successful when such assets programs include both matching deposits and financial education.

President Obama's budget includes both a universal employer-based retirement savings program, part of which is based on the Automatic IRA proposal developed by Mark Iwry or Brookings and me. It also includes changing the savers credit so that it becomes a match that goes directly into the account. It would be relatively simple to develop an workplace-based payroll-deduction savings account that starts when a worker enters the workforce and includes both a retirement section and a linked savings account that could be used for the down payment for a first home or similar use. When the worker is young, most of the money would go to the savings account and less to retirement, but as the worker ages, the proportion would gradually and automatically shift so that eventually all of that money goes to retirement savings. Such a plan would make it easier for millions of Americans of all income levels to save for a home.

This concludes my testimony, and I look forward to any questions.

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